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ROW HOUSE REHABILITATION: BACK BAY

CASH FLOW AND RESALE ANALYSIS

Calculations are presented which show the effect of first and second mortgage financing on the profit expected by the private owner or developer interested in the high quality rehabilitation of a Back Bay row house. Some rehabilitation will cost less. These calculations are for total modernization.

Net return on equity invested is calculated for each year, and for the sale of the property at the end of a ten year period.

Certain assumptions are made:

1) That a party willing to rent at the levels described demands certain amenities (such as wall to wall carpeting, air conditioning, duplex units, clean and new kitchens with dishwashers, clothes washer and dryer, etc) in a stately row house.

2) That this amenity can be provided through acquisition and rehabilitation at a total cost of $29,000 per floor in a five (5) story row house structure.

3) That mortgages can be bought at the costs indicated (if they go down refinancing is possible which will increase profit).

4) That the developer can use the full value of the depreciation available or that he can "sell" it equivalently (i.e. to one in a 50% tax bracket).

5) That 150% declining balance depreciation for a 40 year life will be continued as a deduction by the Internal Revenue Service.

6) That rents and real estate taxes and operating expenses will rise proportionally (increases in rents beyond increases in taxes will increase profit).

7) That resale at the price of total cost to the developer is possible at the end of a ten year period. In fact appreciation of 9 to 11 % per year has been observed in the Back Bay since 1958. This further increases return upon resale.

8) That the PROFIT margin indicated is sufficient to allow reasonable deviations from costs as listed below.

Acquisition & Renovation:

85,000 purchase price
12,000/ floor rehab
145,000 total cost

Rent Roll

1 duplex	@850	850
(3) 2 bedrm	@425	1275
(1) 1 bedrm	@350	350
		2475/mo.

Gross Income: Gross annual rents = 29,700

Mortgage:

8½ % interest 75 % Mortgage = 108,750/for 25 years
1½ % amortization in 1st year Equity 36,250
11 % constant Servicing Charge = 11,962/year

Expenses:

Operating and maintenance	2300
Real Estate Taxes, Valuation at 50 % (at 30 % of gross = 11,160)	10440
Vacancy Allowance (3 average units empty for 1 month each)	1200
TOTAL EXPENSES	13940

Depreciation:

Value of building 80 % X 85,000 =	68,000
Rehabilitation	60,000
Depreciable Assets	128,000
@ 150 % declining balance, in first year	4,800

Internal Revenue Computation:

Gross Income		29,700
Expenses	-	13,940
Net before mortgage service		15,760
Interest first year	-	9,243
Depreciation	-	4,800
		1,717
Profit		
Tax (@ 50 % tax bracket)		858

Return:

Net		15,760
Mortgage Service	-	11,962
Taxes	-	858
Net Profit		2,940

Return on Equity:

$\frac{2940}{36,250}$ = 8.1 % in first year

Second Mortgage:

@ 15% of total cost = 21,750
12% interest = 2,610/year
Equity 36,250 - 21,750 = 14,500

I.R.S. Computation:

Net Profit		1710
Interest on Second Mortgage	-	2610
Net	-	893
Tax Advantage	+	446

Return:

Net before servicing		15,760
First Mortgage Service	-	11,962
Second Mortgage Service	-	2,610
Tax Gain	+	446
Net Profit after Taxes		1,634

Return on Equity:

$\frac{1634}{14,500}$ = 11.3 % in first year

Cash Flow - 10 year period:

Year	Depreciation @ 150% d.b.	Interest 1st Mortgage	Net for I.R.S.	Amortization	Income Tax	Net after Taxes PROFIT
1	4800	9243	- 893	2719	- 447	1634
2	4620	9013	- 483	2949	- 242	1430
3	4447	8762	- 59	3200	- 30	1218
4	4278	8490	+ 382	3472	+ 191	997
5	4120	8195	835	3767	418	770
6	3965	7875	1310	4087	655	533
7	3816	7527	1807	4435	904	284
8	3673	7150	2327		1164	24
9	3536	6741	2873	5221	1436	- 248
10	3403	6279	3450	5665	1725	- 537

Present Value Analysis

1. 15% expected annual return
2. sale at year 10 for $185,000 - existing income capitalized at 9% + 9% property appreciation

Analysis A:

	Present Value of $1		Net Return after Taxes		Present Value
1	.86957	x	1634	=	1420
2	.75614		1430		1081
3	.65752		1218		801
4	.57175		997		571
5	.49718		770		382
6	.43233		533		230
7	.37594		284		107
8	.32690		- 24		- 8
9	.28426		- 248		- 70
10	.24718		- 537		- 132
	.24718	x	40,001		+ 9888
Present value of the 10 year income stream				=	14,270

Cost		145,000
Depreciation		40,658
Book Value		104,342
Resale Price		185,000
Capital Gain		80,658
Tax @ 25%		20,164
Resale Price		185,000
Second Mortgage Principle due	-	21,750
First Mortgage Principle due	-	103,085
Capital Gains Tax	-	20,164
Net received from sale @ year ten		40,001

The amount one would be willing to invest today to receive a 15% return is $14,270. This is the amount of equity invested after the second mortgage and indicates that in this example the return is approximately 15 % annually.

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CONCLUSIONS

Quality rehabilitation of the typical Back Bay row house (especially the 24' wide variety) is possible for either the resident-owner or the private developer at a reasonable profit.

The resident-owner who is willing to sacrifice some of the yield from his property in return for longer term residence without the trouble of refinancing at certain intervals should be satisfied with the 10 to 15 % average return indicated over the life of his 25 year mortgage.

The developer interested in a higher return will be quite willing to refinance or sell his property after 6 to 10 years from the date of his purchase in order to realize the 15 to 20 % average annual return computed.

This reasonable rate of return is contingent upon the receipt of rents of at least the levels previously indicated (1 bedroom unit @ $350/month; 2 bedroom unit @ $425/month; duplex with 4 or 5 bedrooms @ $850/month).

If landlords are allowed to continue to take profits from the substandard, subdivided, and overcrowded units at the present rental levels, then there is no reason to expect any pressure to cause the careful rehabilitation required for the restoration of the character of most of the Back Bay or the return of those upper income persons who demand such amenity. This over-occupancy must be prevented by a program of strict code enforcement coupled with the assertion of a policy requiring educational institutions to recognize their responsibility to house their populations.

It is not clear that the introduction of new high-rise condominium units will encourage this rehabilitative effort. Rather, it seems quite possible that the new high-rise construction will effectively divert the demand and supply for quality rehabilitated units.

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